

# CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

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Page 1 of 18

## Table of Contents

<b>CH. 1</b>	<b>INTRODUCTION.....</b>	<b>2</b>
<b>1.1</b>	<b>INTRODUCTION TO WATER'S-EDGE .....</b>	<b>3</b>
a.	What Is Water's-Edge? .....	4
b.	Water's-Edge Election By Contract—Taxable Years Beginning Prior To January 1, 2003 .....	6
c.	Water's-Edge Statutory Election—Taxable Years Beginning On Or After January 1, 2003 .....	7
d.	Water's-Edge Dividend Deduction And Foreign Investment Interest Offset .....	8
e.	A Note On Terminology .....	10
<b>1.2</b>	<b>HISTORY OF WATER'S-EDGE LEGISLATION .....</b>	<b>11</b>
<b>1.3</b>	<b>FEDERAL INTERNATIONAL TAX ISSUES AND THE CALIFORNIA SYSTEM OF ALLOCATION AND APPORTIONMENT .....</b>	<b>15</b>

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## **CH. 1      INTRODUCTION**

### **CONTENTS:**

- 1.1    INTRODUCTION TO WATER'S-EDGE**
- 1.2    HISTORY OF WATER'S-EDGE LEGISLATION**
- 1.3    FEDERAL INTERNATIONAL ISSUES AND THE CALIFORNIA SYSTEM  
         OF ALLOCATION AND APPORTIONMENT**

## **1.1 INTRODUCTION TO WATER'S-EDGE**

### **CONTENTS:**

- a. What Is Water's-Edge?**
- b. Water's-Edge Election By Contract—Taxable Years Beginning Prior To January 1, 2003**
- c. Water's-Edge Statutory Election—Taxable Years Beginning On Or After To January 1, 2003**
- d. Water's-Edge Dividend Deduction And Foreign Investment Interest Offset**
- e. A Note On Terminology**

## **a. What Is Water's-Edge?**

In 1986, legislation was enacted in California to permit a "water's-edge election" to be made by certain taxpayers. (Stats. 1986, Chapter 660; Revenue and Taxation Code (RTC) §25110, et seq.) The water's-edge law was the most significant change in California Corporation Tax Law, affecting multistate and multinational apportionment, since the 1966 enactment of the Uniform Division of Income for Tax Purposes Act (UDITPA). (Stats. 1966, Chapter 2; RTC §25120, et seq.)

Discussed in more detail in Section 1.2, Water's-Edge Manual, the water's-edge legislation was intended primarily to restrict California's application of the worldwide combined reporting method of determining income from California sources. Rather than ban worldwide combined reporting, the water's-edge legislation provided another option to taxpayers. If a taxpayer would pay more tax under the worldwide method, it may choose to pay less tax by making a water's-edge election. In addition, for some taxpayers, filing on a water's-edge basis requires less record maintenance.

By electing water's-edge, a taxpayer elects into a system of taxation, which represents a peculiar blend of federal and state taxation concepts. This blend is the subject of Section 1.3, Water's-Edge Manual. Stated very broadly, under water's-edge, the scope of combined reporting is limited to certain corporations (or portions of corporations), whose income is subjected to tax (directly or indirectly) by the United States (US) government. For example, an entity incorporated in the US is generally subject to US taxation on all of its income; and it is includible in a water's-edge combined report. In contrast, an entity incorporated in a foreign country, which lacks certain connections with the US, is not subjected to US taxation; and it is not included in the water's-edge combined report. Between these two extremes is a host of entities, e.g., controlled foreign corporations with Subpart F income, foreign sales corporations, domestic international sales corporations, etc., for which the federal tax system and the water's-edge system have special rules. (See RTC §§25110(a)(1)—(6) for the tests applicable to determine if a particular entity, or part thereof, is includible in the water's-edge combined report. These tests are discussed in Chapter 2, Water's-Edge Manual.)

This similarity between the federal system and the water's-edge system is, however, subject to one extremely important limitation: the unitary business concept. The water's-edge rules do not override the unitary business concept, or the apportionment and allocation rules of UDITPA. (RTC §25110(7)(A).)

Corporations must be engaged in a unitary business to file a combined report, whether they file on a worldwide or water's-edge basis. (Note the reference to RTC §25101 in RTC §25110(a); RTC §25110(7)(A), et seq.) However, the

water's-edge rules provide an additional test, or set of tests, to determine which entities are includible in a combined report. In other words, under water's-edge, a corporation has to meet two tests to be included in a combined report.

It must:

1. Be engaged in a unitary business with a water's-edge electing taxpayer.
2. Meet one of the specific water's-edge inclusion tests in RTC §§25110(a)(1)-(6). (As discussed in Chapter 2, Water's-Edge Manual, an entity need meet only one of the tests in RTC §25110 for mandatory inclusion in the water's-edge combined report. The fact that it fails to meet all of the tests is irrelevant. By failing to meet all tests, then an entity is excluded from the water's-edge combined report. The water's-edge legislation does not define what is excluded, but rather what is included (with the notable exception of possession corporations electing under Internal Revenue Code (IRC) §936.) Corporations that are excluded is, therefore, defined by exception.)

Perhaps the easiest way to think of the water's-edge combination is as a "carve-out." Start with the worldwide unitary business group and "carve-out" the corporations that meet the water's-edge tests. These are the entities that comprise the water's-edge combined reporting group. All other entities are excluded from the water's-edge combined group. A water's-edge election does not affect a corporation's unitary relationship. A unitary business is still required for combined reporting to apply.

A very significant feature of water's-edge is the use of the federal system for income tax treatment of international transactions. Much of the following text is devoted to these transactions. Chapter 6, Federal International Issues Overview, provides a broad basis for understanding the federal tax system and its relationship to California's water's-edge combined reporting.

Water's-edge combined reporting involves consideration of a number of interesting concepts, which have little or no application under worldwide combination rules. Water's-edge combined reporting may be broken down into the five key aspects:

- 1) Definition of the water's-edge group; the corporations required to be included in the water's-edge combined reporting.
- 2) Use of federal international tax rules.
- 3) Election rules.
- 4) Dividend deduction.
- 5) Foreign investment interest offset.

**b. Water's-Edge Election By Contract—Taxable Years Beginning Prior To January 1, 2003**

Apart from federal international issues, a significant feature of the water's-edge system was the water's-edge "contract." (RTC §25111(a) provides, "A water's-edge election shall be made by contract with the Franchise Tax Board...") This contract provided a means for enforcing certain conditions of the water's-edge election. Both the Franchise Tax Board (FTB) and the water's-edge electing taxpayer had responsibilities and rights under the contract. Under the contract, the auditor was required to follow certain procedures in examining certain issues. The taxpayer's responsibilities included an obligation to be subject to the water's-edge rules and to forego the right to file a worldwide combined report for at least seven years.

The election period could be terminated within the seven-year period only under certain circumstances. The seven-year period automatically continued for a longer period. It was subject to detailed rules concerning when and how the election started, and when and how the termination or the automatic rollover was initiated. A condition of the water's-edge election contract was that all taxpayers engaged in the unitary business had to make the water's-edge election. (RTC §25111.) These contract rules are discussed in Chapter 3, Water's-Edge Manual.

**c. Water's-Edge Statutory Election—Taxable Years Beginning On Or After January 1, 2003**

The provisions for making a water's-edge election were substantially changed with the enactment of Senate Bill (SB) 1061. (Stats. 2003, Chapter 633; RTC §25113.) SB 1061 created new procedures pursuant to RTC §25113, which replace the election by contract with a statutory election. The statutory election:

- Continues to be made for a seven-year (84-month) period.
- Is made on a timely filed, original return for the year of the election.

RTC §25113:

- Codified the “substantial performance” concept that is present in the regulations. This prevents taxpayers that inadvertently fail to satisfy a procedural aspect of the election from losing their water’s-edge status.
- Eliminated the automatic renewal provisions. The taxpayer elects for an initial seven-year (84-month) period and the election remains in place thereafter until terminated.
- Allows taxpayers to request and receive FTB consent to terminate the water's-edge election prior to the seven-year (84-month) period for good cause. Good cause for these purposes has the same meaning as specified in Treasury Regulations (TR) §1.1502-75(c). If a taxpayer is granted termination and returns to filing on a worldwide basis, then the taxpayer must file on a worldwide basis for at least seven taxable years before making another water’s-edge election. However, the FTB may waive the application of this prohibition period for good cause.
- Provides that taxpayers that have a valid election for taxable years beginning before January 1, 2003, will continue to file on a water's-edge basis and will be deemed to have elected under the new rules (RTC §25113.) However, the election start date under the new rules will continue to be the start date as originally elected under the old rules (RTC §25111.)

#### **d. Water's-Edge Dividend Deduction And Foreign Investment Interest Offset**

The last item noted in this brief introduction is the deduction for dividends and accompanying interest offset applicable to US-based multinational corporations. In a water's-edge combined report, the foreign subsidiary of a US corporation is generally excluded from the combined report, unless the foreign subsidiary meets one of the inclusion tests. Dividends received by the US corporation from an excluded subsidiary are taxable income under both US and California tax concepts. In a worldwide combined report, such dividends are eliminated in computing worldwide business income subject to apportionment, to the extent that they are paid out of earnings and profits (E&P) included in the unitary business. But this elimination is conditioned on the foreign subsidiary being included in the California combined report, and such condition is obviously not met where the subsidiary is excluded under a water's-edge election. (RTC §25106.) Thus, for example, if a foreign subsidiary were to distribute all of its E&P for a given water's-edge year, its entire income would be included in the parent corporation's water's-edge combined report. However, none of the apportionment factors which, in theory, contributed to the earning of that income would be given any weight.

US parent corporations argued that such dividends were "foreign source" income and that their inclusion in the combined report effectively taxed the operations of their foreign subsidiaries. A foreign parent, on the other hand, generally may exclude all of its foreign source income from the water's-edge combined report. To counter this perceived inequity, the water's-edge rules provide for the foreign dividend deduction.

As a general rule, a 75% deduction is allowed. For taxable years beginning on or before January 1, 1996, the deduction was subject to an increase if the multinational enterprise decreased its relative payroll expense outside the US. Or, the deduction was subject to a decrease if the multinational enterprise increased its relative payroll expense outside the US. (RTC §24411.) In 1996, legislation was enacted, which simplified the computation of the RTC §24411, the foreign dividend deduction. (SB 38, Stats. 1996, Chapter 954; RTC §24411.)

Effective for taxable years beginning on or after January 1, 1996, RTC §24411 was amended to allow a flat 75% deduction for all qualifying dividends received. The dividend deduction is limited, however, by the extent to which the water's-edge group has incurred interest expense for the purpose of making investments in foreign subsidiaries, the foreign investment interest offset. (RTC §24344(c).) This "interest offset" to the dividend deduction is defined by means of California regulations, based in large part on comparable federal rules for determining whether interest expense is a US or foreign "source" expense. (Compare CCR §24344(c) and TR §1.861-8(e)(2).) The TRs are effective through 1986.



The federal rules applicable for taxable years beginning after December 31, 1986, are TR §1.861-8T(e)(2) and TR §1.861-9T-13T. (T.D. 8228, 1988-2 CB 136.) The water's-edge dividend deduction is discussed in Chapter 13, Water's-Edge Manual, and the foreign investment interest offset is discussed in Chapter 14, Water's-Edge Manual.

**e. A Note On Terminology**

Recognize as you proceed through this manual that certain terms are used that have connection with long established California tax law. Although you are familiar with these terms, these same terms are used in entirely different context, and have entirely different meanings, in the federal international taxation area. Each of these key aspects of the water's-edge rules is the subject of one or more chapters in this manual.

## 1.2 HISTORY OF WATER'S-EDGE LEGISLATION

California's water's-edge legislation was a product of controversy over the application of the worldwide unitary business concept to multinational corporations. This controversy spanned many years and, indeed, continues. It has involved California and many other state legislatures, the US and foreign governments, and the diverse interests of US-based and foreign-based multinational corporations. Battlegrounds included US tax treaty negotiations, the US Congress, foreign parliaments, state legislative sessions, the press and the courts.

Through the 1960s and 1970s (as one of the largest state taxing authorities), the FTB was increasingly aggressive in promoting and applying the unitary method to multinational businesses. Although a number of other states also applied the unitary method to multinationals, California was by far the most economically significant of those states. It naturally attracted a lion's share of the criticism for the unitary method. This period of time coincided with continuing overseas expansion of US-based multinationals, and with the significant expansion of foreign-based multinationals in the US. These developments increased the importance of the worldwide unitary method, and led to intensification and broadening of the controversy.

Matters came to a head in 1975 when negotiators for the US Treasury Department agreed with their United Kingdom (UK) counterparts that the new US-UK tax treaty should include a provision, which would have outlawed application of the unitary method to UK-based multinationals. During the ensuing three years, that provision was the subject of intense lobbying of the US Senate by the multinationals and the states. In 1978, the Senate disapproved the unitary provision, while it approved the remainder of the treaty. In 1985, the British efforts were elevated when Parliament enacted legislation authorizing the UK Treasury to deny tax credits normally available to foreign shareholders of British companies, if those shareholders did business in states that employed the worldwide unitary method. The UK never actually denied the credits. Instead, it used the threat as a means to persuade others to abandon worldwide combined reporting. (For a summary of the UK legislation, see Stephen E. Flamma, "UK Retaliation Against Unitary Taxation," Tax Notes, September 2, 1985, p. 1137.)

Following the defeat of the UK treaty provision, the courts became the forum for the unitary controversy, and the US Supreme Court ruled on a number of issues related to the controversy from 1978 through 1983. Several of these cases, *Japan Line*, *ASARCO*, and *Woolworth*, offered hope to the multinationals that the Court would find a way to invalidate worldwide combined reporting. (*Japan Line, Ltd. V. County of Los Angeles* (1979) 441 US 434. *ASARCO Inc. v. Idaho State Tax Commission* (1982) 458 US 307. *F.W. Woolworth Co. v. Taxation and Revenue Department* (1982) 458 US 354. Outcomes of other cases, however, may have offered encouragement to the states: *Mobil Oil Corp. v. Commission*

*of Taxes* (1980) 455 US 425, and *Exxon Corp. v. Wisconsin Department of Revenue* (1980) 455 US 425.)

However, in *Container Corporation v. FTB*, the US Supreme Court ruled that California could apply the unitary concept to the worldwide operations of a US-based corporation. (*Container Corporation v. FTB* (1983) 463 US 159.) Although the court left open the question of whether application of the concept to a foreign-based multinational would be permitted, the *Container* decision signaled to multinationals and their supportive foreign governments that judicial resolution of the controversy on a basis favorable to them was unlikely, or at least not foreseeable in the near future.

In the aftermath of *Container*, the multinationals and the foreign governments asserted pressure on the Ronald Reagan Administration to undertake an active role in the resolution of the controversy. As a result in late 1983, Treasury Secretary Donald Regan established a "Working Group" of representatives of the states and the multinationals, and others, to study the problem and propose solutions. Governor Deukmejian of California was a member of the Working Group. The Working Group appointed a Task Force to assist it in its work.

The Task Force held discussions and conducted hearings. In May 1984, it released a report drafted on its behalf by US Treasury Department staff members. (The report is available in Tax Notes, May 7, 1984, p. 637.) The Task Force developed six options for restricting application of worldwide combined reporting, but Treasury Secretary Regan was not successful in getting the multinationals and the states to agree on one of the options. Ultimately, the Working Group announced it had definitely determined that the states were willing (which they were not) to abandon worldwide combination if the US-based multinationals were willing (which they were not) to allow apportionment of foreign dividends and inclusion of "80/20" companies. (An 80/20 is a US-based corporation with 80% of its activities conducted in a foreign country.) Treasury Secretary Regan announced that a compromise of this fundamental disagreement would be "worked out in the state legislatures." ("Unitary Method Working Group Agrees to Disagree," Tax Notes, May 7, 1984, p. 571.)

The issues discussed by the Working Group became an agenda for consideration by state legislatures. Several of the issues became the objects of express statutory provisions in the California water's-edge law, e.g., the dividend deduction under RTC §24411 and the domestic disclosure spreadsheet of former RTC §25401(d). State tax administrators were concerned that a shift to water's-edge method would have dire consequences. Other issues, such as commitments by the US Treasury for increased IRC §482 pricing audits and providing training to state auditors, became the means for addressing these concerns.

Almost immediately following the Working Group's report, a number of states enacted water's-edge legislation. In California, however, worldwide combination was more long lived. For many years prior to 1984, legislation opposed to worldwide combination had been introduced in California each legislative session. In the 1984 session, such legislation did not fare well again, but it became clear that some sort of water's-edge reform would be enacted soon. 1985 legislation, which would have permitted a water's-edge election, came very close to passage, but failed in the final hours of the session. In 1986, the proponents of water's-edge finally broke through, enacting SB 85. (Stats. 1986, Chapter 660.)

The 1986 legislation included provisions for a ten-year election term, an election fee, limited dividend relief and a domestic disclosure spreadsheet. (Limited dividend relief and the spreadsheet were based on the Working Group's report.) The lengthy election term and the fee were Californian innovations. 80/20 companies were included in the water's-edge combined report. The 80/20 issue was resolved against domestic-based multinational opposition. However, the Legislature did call for the FTB to study the issue and report within a year. California diverged from the Working Group's scheme by excluding US possession corporations, and by substituting a "Subpart F" partial inclusion combination rule instead of full inclusion of tax haven corporations.

From nearly everyone's point of view, the 1986 legislation revealed a number of technical problems, as well as substantive problems. The multinationals sought to redress many issues, e.g., the lengthy election term, the fee, the spreadsheet and the included 80/20s. Water's-edge reform legislation passed in 1988, which shortened the election term to five years and reduced the burden of the spreadsheet. However, 80/20 corporations remained in the water's-edge combined report. (Stats. 1988, Chapter 989.) The legislative amendments applied to taxable years beginning on or after January 1, 1988. Thus, portions of the original legislation never became operative.

Significant water's-edge reform legislation was passed again in 1993, effective for taxable years beginning on or after January 1, 1994, to address "business climate" concerns of the multinationals and threats by the UK to implement its legislation denying tax credits to US shareholders of British companies. (Stats. 1993, Chapter 881.)

This legislation:

- Repealed RTC §25115, the election fee, effective for taxable years beginning on or after January 1, 1994.
- Repealed the Domestic Disclosure Spreadsheet filing requirement. (RTC §25401d, renumbered to RTC §18634, was substantially amended effective for taxable years beginning on or after January 1, 1994. It was

repealed, effective for taxable years beginning on or after January 1, 1996.)

- Repealed FTB's ability to disregard an election for specified reasons.
- Extended the contract period to seven years (eighty-four months).

Water's-edge legislation has been the subject of challenges in the courts. Shortly after the first election fees became due in mid-October 1989, lawsuits were filed on behalf of a number of multinationals alleging that the fee computation was unconstitutional. These suits were withdrawn when the election fee requirement was later eliminated.

Efforts to redress the remaining contentious issues continued. Legislation continued to be introduced that would exclude 80/20 corporations, provide 100% dividend relief, and repeal the foreign investment interest offset.

The most significant challenge to the water's-edge system was the challenge to mandatory worldwide combined reporting. Mandatory worldwide combined reporting was finally resolved in 1994. In June 1994, the US Supreme Court issued decisions upholding worldwide combination for both foreign-based and domestic-based multinationals. (*Barclays Bank Plc. v. FTB* and *Colgate-Palmolive Co. v. FTB*.) After the US Supreme Court *Barclays* decision, there has been a 50% increase in the number of water's-edge elections.

Refining of the water's-edge rules continues to occur. In 1996, SB 38 passed and simplified the RTC §24411 foreign dividend deduction. For taxable years after January 1, 1996, RTC §24411 allows a 75% deduction for qualifying dividends received. In 2003, SB 1061 passed and simplified the election process. For taxable years after January 1, 2003, RTC §25113 contains the new rules for making a water's-edge election.

The California water's-edge method developed out of controversy and was resolved by means of, what was at times, an intense political debate. The water's-edge rules reflect the specialized interests of the proponents of the legislation, as well as its opponents. Although certain aspects of the water's-edge combination are logical, some aspects are the product of the political process. Regardless, California's water's-edge combined reporting has become a significant filing option for multinationals operating in California.

### **1.3 FEDERAL INTERNATIONAL TAX ISSUES AND THE CALIFORNIA SYSTEM OF ALLOCATION AND APPORTIONMENT**

As discussed briefly in the introduction, there is a similarity between the water's-edge system and the federal system of income taxation. In broad terms, water's-edge combined reporting is coextensive with the application of the federal income tax rules to US corporations and to foreign corporations engaged in business in the US. Nevertheless, it would be a mistake to carry this analogy too far. Federal tax jurisdiction has a very different foundation from state tax jurisdiction, and the details of how the federal and California systems work are very different.

As discussed in more detail in Chapter 6, Water's-Edge Manual, Federal International Issues Overview, federal income tax jurisdiction is defined by statutory law. It is not subject to the US Constitutional limitations, which apply to state income taxation. As to US incorporated entities, for example, the US government asserts jurisdiction to tax all of their income, regardless of whether its source is within or without the US. (IRC §11.) California, on the other hand, is constrained to tax only income that has its source in this state. This rule is expressed in RTC §25101. The overriding consideration is that California's jurisdiction to tax is limited by the Due Process and Commerce Clauses of the US Constitution. (See, for example, *Mobil Oil Corporation v. Commission of Taxes of Vermont* (1980) 445 US 425, and *ASARCO, Inc. v. Idaho State Tax Commission* (1982) 458 US 307.)

This different jurisdictional basis for taxation is reflected in how the federal tax system operates in contrast to the operation of the California system. The scope of the water's-edge combined report may bear a strong resemblance to the federal consolidated tax return. Both include commonly controlled entities incorporated in the US. (For the requirements for inclusion in a federal consolidated return see IRC §§1501 and 1504. Also see Chapter 2, Water's-Edge Manual for a discussion of the water's-edge inclusion rules.) However, all of the income of the federal consolidated group is taxable by the US, including that derived from sources outside the US. (IRC §§11, 1502 and 1503.)

California may only tax value, the income earned within its borders. When the taxpayer's business operations cross state borders, then the income must be apportioned among the states. Implicit in this apportionment scheme is the unitary business concept. It is the income of a unitary business, which must be apportioned. If two discrete businesses are conducted in two different states, then there is no unitary business and no apportionment requirement. In that case each state may only tax the income of the one business earning income within its borders. It would have no jurisdiction to tax the earnings of the other business. (*Mobil Oil Corporation v. Commission of Taxes of Vermont* (1980) 445 US 425.)

Example:

Corporation A and Corporation B are affiliated and eligible to file a federal consolidated tax return. A engages in the business of manufacturing and distributing baseball bats in California and throughout the world. B engages in the business of franchising restaurants in the state of Texas. A and B are not engaged in a unitary business.

Although A and B may file a federal consolidated tax return, it would not be coextensive with A's California water's-edge combined report. B may not be included in that combined report because it is not engaged in a unitary business with A. Moreover, California may only tax the income of A, which is derived from sources within California.

The second broad area of distinction between the federal and the water's-edge systems is in the manner of dealing with international operations and transactions. Chapter 6, Water's-Edge Manual, Federal International Issues Overview, discusses the federal system taken as a whole, and subsequent chapters consider the details of specific federal issues, which are important in audits of water's-edge tax returns.

As noted above, the US government asserts jurisdiction to tax all of the income of a US-incorporated entity, regardless of source. It could be said that the US taxes the "worldwide income" of such corporations. (Michael J. McIntyre, The International Income Tax Rules of the United States, Butterworth Legal Publishers, 1989, p. 1-14.) But this is quite different from the concept of "worldwide income" used within the context of worldwide combined reporting. In the federal scheme, "worldwide income" is all of the income of that one corporation; it has nothing to do with the income of the foreign subsidiaries of that corporation.

Example:

Corporation A engages in the business of manufacturing and distributing baseball bats in California and throughout the world. Its subsidiary, Corporation B, is the sole distributor of Corporation A's products in West Germany, and was formed under the laws of that country. Corporations A and B are engaged in a unitary business.

For California worldwide combined reporting purposes, the "worldwide income" subject to apportionment for A would include the earnings of both A and B. But, for federal purposes, the "worldwide income" of A is simply A's separate accounting income. Although that may include dividends and receipts from the sale of products to B, B's income is not included in A's income subject to federal tax. Moreover, in the event A were to make a California water's-edge election,



similar to the federal conception of "worldwide income," Corporation B would be "carved-out."

Although the federal government asserts jurisdiction to tax the "worldwide income" of a US corporation, it still distinguishes between the corporation's "US source" and "foreign source" income. (See IRC §§861-865, and the regulations thereunder.) This is done because a principal goal of the US tax system is to harmonize international trade and other economic relationships by avoiding international double taxation. Where a US corporation earns income in a foreign country, that foreign country may assert jurisdiction to tax the same income because it is sourced in that country. Since the US asserts jurisdiction to tax the same income because its earner is domiciled in the US, double taxation will arise absent some relief provision. In the US, such relief is afforded by means of the "foreign tax credit." (IRC §§901 and 902.)

Example:

Corporation A, incorporated in the US, conducts its business in the US and in Canada. It earns \$100 in the US and \$50 in Canada, for total earnings of \$150. The total earnings are subject to tax by the US, but that tax is subject to a credit for taxes paid to Canada on the \$50 of Canadian source income.

These sources of income and foreign tax credit rules are described in more detail in Chapter 6, Water's-Edge Manual. While these two concepts are key to the federal system, they find no direct application in the water's-edge system. The federal international system, with the application of IRC §482, §367 transfers, Subpart F income, tax treaties, etc., may tax foreign source income. However, it encompasses the distinction between US and foreign source income, with a central theme of avoiding international double taxation by means of providing the foreign tax credit. Although knowledge of the federal system and its application to California water's-edge tax returns is essential, this distinction between US and foreign source income and this theme of avoiding international double taxation are not part of the California system of taxation for two reasons.

First, California has no provision for allowing a credit for taxes paid to foreign jurisdictions because there is no need for one. The reason that the federal government needs to allow a credit is to avoid international double taxation of the same income is because the federal government asserts jurisdiction to tax without regard to the source of income. However, California only taxes income sourced in California. It has no need to redress international double taxation; none exists.

Second, the federal method of sourcing income is generally irrelevant to California water's-edge tax returns because the California and federal methods of sourcing are different. California may only tax California source income, as determined under the apportionment and allocation rules of UDITPA. (RTC

§25120, et seq.) But the geographic source of income for federal purposes is determined under a different scheme as provided in IRC §§861 through 865. The California and UDITPA geographic sourcing method emphasizes formula apportionment; the federal method emphasizes an analysis of the transactions that result in the realization of income. “California source” is a concept very different from “US source.”